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Recent Local Financial System Reform (Trinity Reform)

Hiroshi IKAWA

Professor, National Graduate Institute for Policy Studies

Council of Local Authorities for International Relations (CLAIR)
The Institute for Comparative Studies in Local Governance (COSLOG)

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The National Graduate Institute for Policy Studies (GRIPS)

1 Introduction

In Japan, local financial system reform (trinity reform) has been carried out with the aim of promoting local administration. As part of trinity reform, three reforms have been carried out as a package in pursuit of fundamental reform in the local financial system, namely reform in the transference of tax revenue sources from the central government to local governments, reform of the “national treasury subsidy and obligatory share” and reform of local allocation tax.

In this report, firstly, the current condition of Japanese local government finances and the problems they face are briefly explained, after which the report sets out the necessity for local financial reform, including the start and purpose of trinity reform. Next, the report gives an overview of the movement of trinity reform from the fiscal years of 2003 to 2005 through the medium of an examination of “Basic policies for economic and fiscal management and structural reform” and the budgetary compilation process. Lastly, the report discusses the results and problems of the trinity reform until now and the future of local financial system reform.

2 The Current Condition and Problems of Local Finances

2-1 Current Condition of Local Finances in Japan

1) Major Annual Expenditures of Local Governments - Japanese Local Governments have to fulfill Many Roles

Japanese local governments (prefectures and municipalities (cities, towns and villages)) are performing a variety of activities in the process of providing administrative services for the daily life of their residents. The role of local finance is also very important in the national economy; specifically, local governments account for a component ratio about three times higher than the central government in gross domestic expenditure. For example, in fiscal year 2004, local governments account for 12.3% (60.9 trillion yen) of gross domestic expenditure (496.2 trillion yen). On the other hand, the central government and social security funds account for 4.1% (20.4 trillion yen) and 6.5% (32.3 trillion yen) respectively of total expenditure. The net aggregate of expenditure in fiscal year 2004, obtained by subtracting the overlap from the total expenditure of the central government (net budget of both the general account and ten special accounts) and local governments (ordinary accounts) was 149,845 billion yen. If the net aggregate expenditure is divided between the central and local government focusing on final expenditure, the central government and local

governments account for 59,896 billion yen (40.0% of the total) and 89,949 billion yen (60.0%) respectively (Note 1).

Local governments perform a variety of activities, such as educational administration in terms of establishing and running elementary schools, junior high schools and high schools, and welfare policy in terms of developing welfare facilities and administering public financial assistance. They also carry out a lot of other tasks which have a considerable impact on people's lives. For example, local governments implement tasks related to medical services, public health, mental health, and other areas, as well as the collection and disposal of garbage and human waste. In addition, prefectural governments perform administrative activities concerned with policing in order to maintain safety and order in local communities. Municipalities perform administrative activities concerned with fire fighting with the aim of preventing disasters and reducing damage from fire. As shown in Fig. 1, from the perspective of expenditure by the central government and local governments on an expenditure function basis, most expenditures directly related to people's life such as sanitation expenses, school education expenses, and judicial, police and fire service expenses are paid by local governments, in contrast to defense expenses and pension expenses which can be managed and paid only by the central government.

2) Major Revenues for Local Governments - Local Taxes, Local Allocation Tax, National Treasury Disbursements, Local Government Loans

Table 1 shows the major revenues of local governments, namely local taxes, local allocation tax, national treasury disbursements, and local government loans.

Local taxes account for about one-third of the revenues of local governments. Local taxes are collected from residents and companies in each region by local governments in accordance with the provisions of the Local Tax Law and bylaws.

The local allocation tax is distributed by the central government in order to equalize the difference in financial resources generated by diversity in economic situations, and ensure a source of revenue as required for a standard level of service by local governments. The local allocation tax is a general revenue source, the use of which is not restricted. It is a common financial resource for local governments, which is similar to local taxes. The total amount of local allocation tax is linked to certain percentages (about 30%; "local allocation tax rate") of five national taxes, including income tax, corporation tax and consumption tax. Currently, local financial resources are insufficient, and the amount of the local allocation tax has been increased, adding an extra amount from the national general account. The amount of the local allocation tax allocated to each local government is calculated on the basis of standard financial needs and standard financial revenues in accordance with provisions of the local tax-allocation law. The approximate balance between standard financial needs and standard financial revenues is distributed to each local government.

The national treasury disbursements are revenue granted by central government on the condition that they are used for expenditure on specific projects and on policies for a specified administrative purpose. It consists of a national treasury obligatory share based on the central government's obligations, and a national treasury subsidy for such purposes as the promotion of specific policies or for financial assistance, etc.

Local government loans are debts repayable by local governments over a period exceeding a single financial year. They are used as financial resources for purposes such as building elementary schools, when a large amount of expenditure is required at one time and where the benefits cover a long period.

Other revenues for local governments include local transfer taxes that belong fundamentally to the local tax category and are transferred by central government to local governments after having been collected temporarily as national taxes, usage charges (rent) which are collected for the use of facilities such as high schools, and other fees collected for clerical work for certain persons such as those applying for the issuance of residency cards.

3) Cash-strapped Public Finances of Local Governments

The central government and local governments are in a bad way financially. Table 2 shows the outstanding long-term debt of the central and local governments. At the end of fiscal year 2006, the central government and local governments have 600 trillion yen and 201 trillion yen in long-term debt respectively. The total obtained by subtracting the overlap amounts to 767 trillion yen. Compared to the end of fiscal year 1995, the outstanding long-term debt of the central government and local governments has increased by 2.0 times and 1.6 times respectively. The total is 1.9 times as large as that at the end of fiscal year 1995, indicating a significant increase. The total of outstanding long-term debt for the central government and local governments is 1.5 times larger than the gross domestic product (GDP). According to OECD, the ratio of "general government gross debt" to GDP in 2007 is 0.5 (U.K.), 0.6 (U.S.), 0.7 (Germany), 0.7 (France) and 1.2 (Italy). The ratio to GDP in Japan is more than 1.7. This is a very high level compared to major advanced countries (Note 2).

The outstanding long-term debt of local government was 39 trillion yen in fiscal year 1980. It has increased gradually to 57 trillion yen in fiscal year 1985 and 67 trillion yen in fiscal year 1990. In the 1990s, outstanding long-term debt increased rapidly. The amount was 125 trillion yen in fiscal year 1995 and 181 trillion yen in fiscal year 2000. The amount has increased by almost three times that of fiscal year 1990 (Note 3). Local government finance has deteriorated because there have been no large increases in tax revenues after the burst of the bubble economy, and local governments have carried out many public works in partnership with central government. Thus, local governments as well as central government are in a very bad condition financially.

2-2 Problems in the Local Financial System

In this situation, the major challenges facing the local government finance system are how to ensure independent management and operation of local governments as well as how to overcome the critical financial situation. The national treasury subsidy and obligatory share system and approval system of local government loans have been singled out as limiting the independence of the financial and administrative operations of local governments. The local allocation tax system has also been criticized because it has calculated local allocation tax from the viewpoint of the amount of project expenses and debt expenditure, and has affected the policies and management of local governments.

Above all, the national treasury subsidy and obligatory share system has come under heavy attack because it impedes the autonomy and independence of local governments, and hinders effective and efficient local management. The national treasury subsidy and obligatory share system has advantages in terms of ensuring the enforcement of policies (projects) required from the central government's point of view. However, it has problems including ① uniform conditions for delivering subsidies disturb the effective execution of projects based on the actual condition of communities, ② projects with a lower priority for local communities are implemented because they can be carried out with lower general revenue sources, ③ procedures for acquiring subsidies and obligatory shares including the formulation and submission of an application, review and inspection are troublesome and generate a lot of clerical costs, ④ management of local governments that relies on subsidies and obligatory shares impedes autonomous financial and administrative management that takes advantages of local conditions and creativity. Therefore, many people believe that national treasury subsidies and obligatory shares should be reduced and rationalized.

On the other hand, there is a large gap in the ratio of annual expenditure to tax yields as between the central government and local governments. In this situation, the major challenge is how to reinforce the sources of local taxes. As described above, local governments account for 60% of the expenditure of the central government and local governments. However, in the distribution of tax yields, for example, in fiscal year 2004, the amount of national tax was 48.1 trillion yen (58.9%) and the amount of local tax was 33.5 trillion yen (41.1%) (Note 4). The ratio between the central government and local governments is 3:2 indicating an inverted structure. Additionally, local taxes account for only a third of the gross total revenue of local governments. This revenue cannot cover even half of the total expenditure of local governments. Hence the view that tax revenue sources should be transferred from central government to local governments so as to increase tax revenues of local governments and ensure a self-governing financial administration. The major challenges in the local financial system include the transfer of tax revenues to local governments and the reform of national treasury subsidies.

3 Necessity, Meaning and Purpose of Local Financial System Reform (Trinity Reform)

3-1 Necessity of Fundamental Reform of Local Financial System

Since the Shoup Report of 1949, the Local Government System Research Council and other provisional research councils have pointed out several times the necessity of reform, reduction and rationalization of the national treasury subsidy and obligatory share system. According to these opinions, improvements and rationalizations have been carried out, such as ① reducing national treasury subsidies and replacing them with general revenue sources such as local taxes and local allocation tax; ②simplifying conditions for subsidies and grant procedures; and ③eliminating the “extra financial burden” that local governments have to pay because the criteria for calculating national treasury subsidies and obligatory shares are inappropriate. However, problems in the national treasury subsidy and obligatory share system have not been completely reformed.

In accordance with the “Law on the amendments of related laws to promote decentralization (the Omnibus Decentralization Act)” which came into force in April 2000, a large-scale reform of the decentralized system was carried out, aimed at an expansion of the autonomy and independence of local governments, such as ① the roles shared by the central and local governments were defined, ②administrative functions imposed upon local governments by central government were abolished (abolition of the system of agency delegated functions),③ the central government’s commitment to local governments was toned down, and ④some authority was transferred to local governments. However, in this primary reform of decentralization, it was mainly the administrative system that was reformed. Reforms in the local financial system were limited to revisions of the approval system of local government loans, etc.

Under these circumstances, the Decentralization Promotion Committee, which made great contributions to the primary decentralization innovations, announced in their final report on June 14, 2001 that the secondary decentralization innovations should be started. They reported that the gap between local tax revenue and annual expenditure of local governments should be reduced on the basis of the principle of “revenue neutrality” whereby the national treasury subsidies and obligatory shares and local allocation tax are reduced, and tax resources equal to the reduced amount are transferred to local governments.

On June 26, the Koizumi cabinet endorsed the first “Basic policies for economic and fiscal management and structural reform.” In this policy, the national treasury subsidies and obligatory shares were restricted to “tasks advantageous to all of Japan or wide areas, and to the maintenance and establishment of necessary administrative services that shall be guaranteed by the central government.” The policy also stated that, “the subsidies and obligatory shares shall be rationalized, local allocation tax shall be revised, and the allocation of tax sources shall be revised and examined from the standpoint of basic principles.” (See table 3 for the chronology of local financial reform.)

3-2 Start of Trinity Reform

As shown above, drastic action was taken to reform the local financial system. In May, 2002, Mr. Katayama, Minister of Internal Affairs and Communications at that time, issued a document entitled “Structural reform of local public finance and transfer of tax revenue sources” (Katayama draft policy) and proposed the “trinity reform”. The basic thinking underlying the reform was to achieve a ratio of 1 to 1 between national and local taxes by transferring to local taxes the amount of 7 trillion yen, or half of 14 trillion yen, which represented the difference between national and local taxes. Mr. Katayama planned to enlarge local taxes by the trinity reform method, firstly by reducing and rationalizing the national treasury disbursement of 5.5 billion yen and transferring it to local taxes (transfer of tax revenue sources), and then by replacing the local allocation tax with local taxes on the basis of improvements in revenue and expenditure.

Additionally, on the basis of a direction from Prime Minister Koizumi, in a Cabinet decision of June 25, 2002, “Basic policies for economic and fiscal management and structural reform 2002” ,the government’s aim was stated as being “to discuss the pattern that should be achieved through trinity reform in terms of the allocation of tax sources including national treasury subsidies and obligatory shares, local allocation tax, and the transfer of tax revenue sources, and to prepare a reform proposal including the most desirable outcome and a specific reform schedule for achieving this, within one year.” Furthermore, the basic 2002 policies aimed to ① form a conclusion within the year about the abolition and/or reduction of the national treasury subsidies and obligatory shares on the basis of the research carried out by the Council for Decentralization Reform, ② reduce national treasury subsidies and obligatory shares by several trillion yen by fiscal year 2006, ③ make an across-the-board revaluation of the financial guarantee functions of the local allocation tax with a view to achieving a reduction by fiscal year 2006.

In October, 2002, the Council for Decentralization Reform that was said to be the successor of the Decentralization Promotion Committee submitted a research paper. However, they were unable to fully discuss or form a considered opinion about the abolition and/or reduction of national treasury subsidies and obligatory shares and transfer of tax revenue sources, thereby failing to meet the expectations of the local government parties concerned. It was in this situation, that a budget for fiscal year 2003 was drawn up. A reduction of about 560 billion yen was made in national treasury subsidies and obligatory shares for local governments, including public works-related subsidies, and in the national treasury obligatory share of compulsory education expenses (mutual aid long-term obligatory share). This was evaluated as the start of trinity reform (See table 4).

3-3 Meaning and Objectives of Trinity Reform

As mentioned above, in trinity reform, tax revenue sources are transferred to local governments, national treasury subsidies and obligatory shares are reformed, and local allocation tax

is revised in an integrated manner. However, there are differences in the way of thinking about the most important item and first priorities, among the transfer of tax revenue sources, subsidy reform, and local allocation tax reform.

The final report of the Decentralization Promotion Committee and the Katayama draft policy aimed to “reduce subsidy and obligatory share as the first priority.” As is clear from this, persons related to the local administration and the Ministry of Internal Affairs and Communications attach a high value to revisions of the national treasury subsidy and obligatory share system and the allocation of tax sources between the central government and local governments with a view to increasing the autonomy and independence of local governments. On the other hand, persons related to the public treasury (Ministry of Finance) and people in the world of economics attach weight to cutbacks in the national treasury subsidy and obligatory share and acceleration of revisions of local allocation tax. They seem to be most interested in achieving financial well-being through revisions by the central and local governments.

Following this link of thought, trinity reform can be said to have two objectives. One is the promotion of the decentralization of power through reform of the national treasury subsidy and obligatory share. That is, the expansion of autonomy and independence of local governments in the field of the local financial system which is a problem that cannot be solved by the primary decentralization innovation referred to above. This can be seen as a reform aiming at a qualitative change in the structure of the local financial system with the aim of constructing a decentralized local financial system.

The other objective is soundness of financial administration on the basis of the critical state of the financial administration situation. With this objective in mind, some people try to promote innovation focusing on revisions and cutbacks in national treasury subsidies and obligatory shares and local allocations tax in order to reduce annual expenditure by the central government and local governments. Their objective is small and effective government and by promoting structural financial reform, they aim to achieve quantitative reductions in central and local government finance. (In the basic policies for 2001, the aim is set out as being “to revise drastically the expenditure of local public finance program, secure required financial resources and achieve local fiscal soundness.”)

The above then are the two objectives of trinity reform. Sound fiscal administration is important for persons involved in local administration. However, the basic objective of trinity reform is to promote the autonomy and independence of local governments, and the decentralization of power. On the other hand, for those persons close to the public treasury (Ministry of Finance) the most important objective of trinity reform is the establishment of sound fiscal administration. The content and characteristics of trinity reform may be different depending on the objectives on which concerned parties place top priority in carrying out the revisions. Consequently, the evaluation of

trinity reform will change depending on the objective to which concerned parties attach a high value.

4 Evolution of Local Financial System Reform (Trinity Reform)

4-1 Trinity Reform in Fiscal Year 2003

In the basic policies for 2002, the government aimed to prepare a reform plan within one year. However, they were unable to complete this task even in fiscal 2003. Finally, they reached some conclusions after receiving directions from Prime Minister Koizumi. On June 27, 2003, the policy document “Basic policies for economic and fiscal management and structural reform 2003” was endorsed by a Cabinet decision. In these basic policies for 2003, specific processes in trinity reform were defined. The policies aimed to ① carry out measures to reduce the national treasury subsidy and obligatory share to approximately 4 trillion yen, ② carry out an overall revision and reduction of the functions of local allocation taxes in terms of guaranteeing financial resources, ③ carefully examine and revise individual projects and while giving consideration to the characteristics of subsidies and obligatory shares, set as a target the transfer by fiscal year 2006 of about 80% of the tax revenue sources to local governments (100% for mandatory projects) with the primary aim of reinforcing the fundamental tax.

After this, there were no further significant developments in the promotion of reform. In October and November, 2003, the Japan Association of City Mayors submitted a list of subsidy abolitions amounting to 5.9 trillion yen and the National Governors’ Association submitted a similar list amounting to 8.9 trillion yen. In this situation, Prime Minister Koizumi directed the reduction of subsidies by one trillion yen in the fiscal 2004 state budget. This accelerated movement in the fiscal 2004 budgetary process. From the side of central government (the Ministry of Health, Labor and Welfare, the Ministry of Finance, etc) the lowering of the subsidy (share) level of livelihood protection payments was stressed as an example of government subsidy reductions and the transfer of tax revenue sources from tobacco taxes was insisted. However, local governments and the Ministry of Internal Affairs and Communications objected to these claims, alleging that the reduction of government subsidies achieved by lowering subsidy (share) level (percentage) did not lead to an expansion of the autonomy and independence of local governments, and the transfer of tax revenue sources had to be made from fundamental taxes such as income tax.

There were therefore confrontations as shown above. However, finally, Prime Minister Koizumi took leadership in the decision-making process. It was decided to ① reduce national treasury disbursement by 1030 billion yen through conversion to a permanent general revenue source (244 billion yen), conversion of a national treasury obligatory share of compulsory education expenses to a temporary general revenue source (231 billion yen) and cutback of public work-related national subsidies (about 550 billion yen) (See table 4), ② grant a special revenue source (656 billion yen) to local governments as a transitory measure before carrying out a full-scale transfer

of tax revenue sources.

Local governments evaluated highly in the trinity reform in the fiscal 2004 state budget ① the reduction of 1 trillion yen in the national treasury disbursement, and ② the retention of the subsidy level of livelihood protection payments and the withdrawal of tax revenue source transfer by tobacco taxes. However, they also criticized the reform, pointing out that the general revenue source was smaller than the reduction in national treasury disbursement, and the central government gave priority to the reconstruction of government finances by a reduction in the financial resources of local governments. Especially it was criticized by local governments with relatively small amounts of local taxes, who had no other choice than to depend heavily on local allocation tax, because the actual total amount of local allocation tax was reduced by 2.9 trillion yen (12%) in realizing the reduction of local allocation tax by 1.2 trillion yen (6.5%) and the reduction of an extraordinary financial measures loan that constituted an alternative revenue source of local allocation tax(See table 5). Many criticized the reform pointing out that they could not put together appropriate budgets because of the insufficiency of their general revenue source.

4-2 Trinity Reform in Fiscal Year 2004

In April, 2004, on the basis of these criticisms by local governments, Mr. Aso, Minister of Internal Affairs and Communications at the time, published the “Local financial reform for the promotion of decentralization (trinity reform).” He asserted that the central government should proceed initially with a decision to transfer about 3 trillion yen of tax revenue sources. However, the Ministry of Finance objected to his assertion that the amount of the transfer of tax revenue sources should be decided only after reducing or abolishing national treasury subsidies and obligatory shares.

However, the document “Basic policies for economic and fiscal management and structural reform 2004” was endorsed by the Cabinet on the direction of Prime Minister Koizumi on June 4, 2004. In this policy document, the government set out its plans to ① transfer tax revenue sources of approximately 3 trillion yen (transfer from income tax to individual inhabitant tax), ② request local governments to prepare specific plans for national treasury disbursement reform amounting to about 3 trillion yen, and on that basis to discuss reform, and ③decide within 2004 on the complete picture of reform for the period up to fiscal 2006.

Six associations of local governments including the National Governors’ Association drew up reform plans for national treasury subsidy and other local finance system reform based on the request of the central government and submitted them to Prime Minister Koizumi on August 24. In the reform plans, the six associations of local governments requested the establishment of a consultative body for the central government and local governments. They also proposed that trinity reform should be divided into a first reform phase (by fiscal year 2006) and a second reform phase (from fiscal 2007 to 2009), that 8 trillion yen of tax revenue sources should be transferred as a whole,

and that the national treasury disbursement of 9 trillion yen should be looked at again. They requested a reduction of 3.23 trillion yen in the national treasury disbursement including 850 billion yen of the national treasury obligatory share of compulsory education expenses (junior high school teacher wages, etc), and 260 billion yen of private nursing center operation subsidies in the first reform phase. They also requested that livelihood protection payments should be eliminated from “transferred national treasury disbursement ”and financial resources of local governments should be secured by means of local allocation tax.

Ministries expressed anger over the proposals by the six associations of local governments . The Ministry of Education, Culture, Sports, Science and Technology reacted sharply against the abolition of the national treasury obligatory share of compulsory education expenses. The Ministry of Health, Labor and Welfare requested a reduction in the level (percentage) of obligatory share of livelihood protection payments. The Ministry of Land, Infrastructure and Transport and the Ministry of Agriculture, Forestry and Fisheries of Japan demanded reform of the national treasury subsidy and obligatory share not by the abolition of the national treasury subsidy and obligatory share but by conversion to grants with a reduced central government commitment. Meanwhile, the Ministry of Finance and expert members of the Council on Economic and Fiscal Policy insisted on reductions in the local public finance program and the promotion of local allocation tax reform.

At the newly established conference between the central government and local governments, the government ministries concerned and the six associations of local governments held consultations. However, they found no room for compromise. Under these circumstances, it was proposed that the entire picture of trinity reform up fiscal 2006 should be re-adjusted, including the ruling parties in the Diet. The government and the ruling parties finally came to an agreement on November 26. The plan set out in the agreement was that in fiscal 2005 and 2006, national treasury disbursement should be abolished or reduced to the extent of about 3 trillion yen and that about 3 trillion yen of tax revenue sources should be transferred through transfer from income taxes to individual inhabitant tax. The parties to the agreement decided to reduce the national treasury obligatory share of compulsory education expenses by 850 billion yen provisionally and to reduce it by 425 billion yen in fiscal 2005 as a stopgap measure. They also decided to reduce the national treasury obligatory share by 700 billion yen by introducing prefectural disbursement into National Health Insurance, a measure which was not proposed in the reform plans put forward by the six associations of local governments. Additionally, they decided to discuss, with a view to reaching a conclusion within 2005, the revisions of state liability in relation to livelihood protection payments and child-care allowances, and the handling of expenses for the public educational facilities.

The fiscal 2005 state budget was put together in accordance with the agreement between the government and the ruling parties. 1768 billion yen of national treasury disbursements were revised. Among them, the sum of 1124 billion yen was revised in connection with the transfer of tax revenue

sources. The amount of transfer of tax revenue sources corresponding to this was determined to be 1116 billion yen. The local allocation tax that was reduced significantly in the fiscal 2004 state budget and came under heavy attack from local governments, showed a 0.1 % increase over the previous year. The reduction of the amount of substantial local allocation tax was only about one trillion yen (4.5%) even when the extraordinary financial measures loan was included (See table 5).

4-3 Trinity Reform in Fiscal Year 2005

There were problems that needed to be solved including the national treasury obligatory share of compulsory education expenses (tentative measure) and livelihood protection payments (agenda). The policy document “Basic policies for economic and fiscal management and structural reform 2005” was endorsed by a Cabinet decision on June 21, 2005. In this document, the government set out its plans to ① realize secure reform based on the agreement between the government and ruling parties in 2004 ②transfer tax revenue sources to the extent of about 3 trillion yen (transfer from income tax to individual inhabitant tax by flattening the tax rate of individual inhabitants tax), ③ reach a conclusion on the remaining problems regarding national treasury disbursement reform by the autumn of 2005.

The problems pointed out in the basic policies for 2005 were resolved by an agreement about “trinity reform” on November 30, 2005 between the government and the ruling parties. The plan set out in this agreement between the government and ruling parties was to revise the national treasury disbursement by about an additional 654.4 billion yen in connection with the transfer of tax revenue sources. As shown in table 4, the total sum of the national treasury subsidy and obligatory share reform related to the transfer of tax revenue sources amounted to about 3 trillion yen, or more precisely 3,117.6 billion yen in total, including 234.4 billion yen resulting from the reform in fiscal 2003, 474.9 billion yen resulting from the reform in fiscal 2004, and 1753.9 billion yen resulting from the agreement between the government and ruling parties in November, 2004. The national treasury obligatory share of compulsory education expenses as a stopgap measure was reduced by 850 billion yen by lowering the ratio of state liability from 1/2 to 1/3 and not by abolition (total eradication) of the national treasury obligatory share of compulsory education expenses for junior high-school. The level of the national treasury obligatory share was maintained for livelihood protection payments. However, the subsidy levels (percentages, of the child-care allowance and child allowance were lowered from 3/4 to 1/3 and from 2/3 to 1/3 respectively. Therefore, a total reduction of 338 billion yen in national treasury subsidy and obligatory share was made.

The fiscal 2006 state budget was put together on the basis of an agreement between the government and ruling parties. The plan in the agreement was to transfer tax revenue sources to the extent of 3 trillion yen in a permanent manner by cutting income tax for 2007 and flattening individual inhabitant tax by income (the proportional tax rate of the individual inhabitant tax was

10% including prefectural inhabitant tax of 4% and municipal tax of 6%). In fiscal 2006, as a provisional measure, the sum of 2179.4 billion yen was handed out to prefectural governments and the sum of 830 billion yen was handed out to municipalities in local transfer taxes (income transfer tax).

5 Results and Problems of Local Financial System Reform (Trinity Reform)

5-1 Results of the Trinity Reform until now

The results of trinity reform until fiscal 2006 will now be explained.

As shown in table 4, the sum of 4666 billion yen in national treasury disbursements was abolished or converted to grants from fiscal 2004 to 2006. If the reform amounting to 563 billion yen in the budget of 2003 is added, the total amount of national treasury subsidy and obligatory share reform comes to 5229 billion yen. This is in excess of 40% of the total amount of 12.5 trillion yen of national treasury disbursements at the time of fiscal year 2004 (See table 1). Within this figure, the amount of national treasury subsidy and obligatory share reform categorized as being related to the transfer of tax revenue sources was 3118 billion yen. The remaining 2111 billion yen was generated by the reduction (abolition or cutback) of national treasury disbursements not related to the transfer of tax revenue sources or conversion to grants. Out of 2111 billion yen, 1317 billion yen was generated by streamlining and 794 billion yen was generated by conversion to grants with a reduced central government commitment.

As mentioned above, the amount of the transfer of tax revenue sources was about 3 trillion yen. All transferred amounts (3009.4 billion yen) were to be covered by income transfer tax in fiscal 2006. For most of the national treasury disbursements reform categorized as being related to the transfer of tax revenue sources, 100% of the amount of abolition and reductions was to be transferred. For facilities subsidies such as subsidies for public school facilities covered by the construction bonds, tax revenue sources for 50% of the abolition and reductions will be transferred.

As shown in table 5, the amount of substantial local allocation tax including the extraordinary financial measures loan comprised the significant reduction from 23.9 trillion yen (the fiscal 2003 budget) to 18.8 trillion yen (the fiscal 2006 budget), i.e. a reduction of 5.1 trillion yen (21.3%). This figure was influenced by the increase in local tax revenues during the period (an increase of 2.7 trillion yen from 32.2 trillion yen to 34.9 trillion yen). However, the most significant impact was that from the reduced scale of the local public finance program, which is closely related to the total amount of local allocation taxes; this reduction in scale had as its target a reduction of expenditure aimed at establishing sound fiscal administration. The scale of local public finance program has been reduced over a period of five straight years with a peak in fiscal 2001. The amount was 83.2 trillion yen in fiscal 2006, indicating a reduction of 3 trillion yen compared to fiscal 2003 (86.2 trillion yen) and a significant reduction of 6.1 trillion yen compared to fiscal 2001 (89.3 trillion yen).

The parties concerned have tried to correct the gap between the local public finance program on the one hand and local government accounting on the other that was seen as a major challenge in 2005 and 2006. The calculation of local allocation tax that was criticized as being too complicated has been simplified. The number of local governments to which no local allocation tax is granted (non-granted bodies) has been increased, and the calculation method has been revised to providing incentives in administrative and financial reform.

5-2 Evaluation of Trinity Reform by Local Governments

Local governments do not necessarily evaluate the trinity reform highly. According to a questionnaire survey addressed to governors and carried out by Jiji Press Co., no governor gave a high evaluation of the agreement of November 2005 between the government and ruling parties, 13 governors considered it to be satisfactory, 20 governors assessed it as less than satisfactory, and five governors felt that it was nonsense. The majority gave a low score to the agreement in their evaluations (Note 5).

The reason why the agreement was not evaluated highly is because trinity reform has not increased the autonomy and independence of local government management as much as expected by local governments. The degree of freedom in forming and executing policies (measures) has not been increased as a result of reducing the national treasury disbursements through the reduction of subsidy (share) levels such as the national treasury obligatory share of compulsory education expenses and state liabilities for child allowances. On the contrary, the general revenue source obligations incurred by local governments in the course of the execution of subsidy projects have increased, and the autonomy and independence of financial and administrative management on the part of local governments may have been reduced. Additionally, as trinity reform is executed, some people criticize the fact that it has become difficult for local governments to manage and execute their financial, administrative and political policies, because the scale of the local public finance program and the total amount of local allocation tax (including the extraordinary financial measures loan) have been significantly reduced with the aim of establishing sound fiscal administration.

Some people evaluate highly ① the 3 trillion yen transfer of tax revenue sources to local governments, ② the establishment of a forum for discussions between the central and local governments, and ③ a certain level of consolidation and rationalization such as the abolition of facility subsidies with regard to national treasury disbursements. However, the reform plan prepared by six associations of local governments in accordance with the request made by the central government is not highly esteemed. The reform of national treasury disbursements has not contributed enough to the improvement of the autonomy and independence of local governments.

Under these circumstances, in which the total amount of local allocation tax is significantly reduced, some people criticize that trinity reform for not focusing on furthering the decentralization

of authority, but only on sound fiscal administration and especially on the reconstruction of the central government finances. Therefore, trinity reform has not necessarily been highly evaluated up to now by persons involved in local administration.

5-3 “Basic Policies for 2006” and Sound Fiscal Administration

Under these circumstances, with a less than high evaluation of trinity reform, the document entitled “Basic policies for economic and fiscal management and structural reform 2006” was endorsed by a Cabinet decision on July 7, 2006. The plan set out in these policies was to establish sound fiscal administration. The period for establishing sound fiscal administration was divided into three phases comprising the first phase (by the end of fiscal 2006), the second phase (from fiscal 2007 to the beginning of the 2010s), and the third phase (from the beginning of the 2010s to the mid 2010s). The parties concerned plan to definitely restore the profitability of basic fiscal revenue and expenditure in the course of fiscal 2011 during the second phase, reconstructing government finances aiming at a balance between the national government and local governments. In the third phase, they plan to stop increasing and to reduce in a stable manner the ratio of outstanding long-term debt relative to GDP. They also estimate that the amount required to restore profitability of basic fiscal revenue and expenditure will be 16.5 trillion yen by fiscal 2011, of which between 11.4 trillion yen and 14.3 trillion yen will be needed for expenditure reform.

In the basic policies for 2006, in the area of local government finance, the parties concerned plan to reduce local expenditure within a framework of cooperation with the central government. They will ① reduce the total number of local government employees (by 5.7%) to the same level as the reduce of central government employees within five years, ② try to revise investment expenditure similar to the revision of central government public works and, ③ suppress general administrative expenditure to the level of fiscal 2006. In terms of local allocation taxes, they will “firmly maintain the current local allocation tax rate, and, by making efforts to reduce annual expenditure as shown above, secure the total amount of the general revenue sources including local taxes and local allocation tax required for the stable management of financial administration.” A certain degree of understanding has been shown in relation to the need to secure the total amount. On the other hand, little attention has been paid to the reform of national treasury disbursements as opposed to the establishment of sound fiscal administration, though there is a mention of a “plan to reduce or abolish national treasury disbursements”. Additionally, in the basic policies, efforts will be made to review public administration in the context of calculating local allocation tax, to review the legal framework for financial reconstruction in an appropriate manner and to establish new guidelines for local administrative reform stressing the importance of sound local government finance.

As mentioned above, under circumstances in which the outstanding long-term debt of the

central government and local governments is 1.5 times larger than GDP, establishing sound fiscal administration is a very important issue. Within local financial system reform (trinity reform), the emphasis seems to be shifting from the decentralization of authority to the establishment of sound fiscal administration. Local governments have thoroughly carried out their own administrative and fiscal reforms such as reduction of the number of employees and revisions of the enforcement of policy. What is important now is for local governments to manage administrative and fiscal operations more effectively than ever and to try to establish sound fiscal administration.

5-4 Future Challenges in the Local Financial System

The major challenges in revising the local financial system in the future include the following items.

First, national treasury disbursements must be revised so as to truly contribute to the decentralization of authority. As mentioned above, six associations of local governments proposed an overall image of trinity reform in August, 2004. The six associations of local governments estimated that the abolition of 9 trillion yen in national treasury disbursements was required. In June, 2006, they proposed a reduction of half of the total number of national treasury subsidies and obligatory shares in the written opinion “Report on the promotion of decentralization”. Using these reform plans as a basis, what they must now do, while anticipating strong opposition from central government ministries and agencies, is to drastically revise national treasury disbursements so as to contribute to the expansion of autonomy and independence of local governments including reviews of national treasury subsidies and obligatory shares that ended by achieving almost nothing more than the reduction of subsidy(share) levels (percentages).

The second important issue is the evolution of future local allocation tax reform. Reconstruction of government finances by the central government and local governments is strongly demanded. The focal point is shifting from an emphasis on the reform of national treasury disbursements to local allocation taxes. The Ministry of Finance has stated that there is a need to ① reduce the amount of the local public finance program and local allocation tax because local government finance is more stable than that of central government, ② review the functions of local allocation tax in terms of guaranteeing financial resources because a blanket degree of protection by local allocation tax is a hindrance to the effective financial and administrative operation of local governments, and ③ discuss the reduction of local allocation tax rate. In response to these assertions, those involved in local administration argue that ① local governments are constantly engaged in rigorously reducing annual expenditure and have no more money to spare, ② there are large difference in financial capability among local governments, and the required financial resources have to be guaranteed by the local allocation tax, ③ the more serious problem in effective local government operation is not the local allocation tax but the national treasury subsidies

and obligatory shares, and ④ it is necessary to eliminate the large deficit in local public finance before reducing the local allocation tax rate.

In the “Report on the promotion of decentralization” mentioned above, the authors propose that the nomenclature “local allocation tax” should be changed to “local common tax” so as to clarify its characteristics as an indigenous financial resource for local governments. Many problems have also been pointed out in the methods used to calculate the local allocation tax, and the Ministry of Internal Affairs and Communications has proposed the introduction of a new local allocation tax based on population and area, the expansion of local governments not in receipt of local allocation tax, and the introduction of calculation methods which take due consideration of administrative and financial reform efforts. Thus, various discussions about the local allocation tax system are going on, and it is clear that the evolution of local allocation tax reform is an important issue for local governments because changes in the total amount and calculation methods of local allocation tax significantly affect the financial and administrative operations of local governments.

Thirdly, it is necessary to draw attention to trends in the reform of the local financial system other than reform in national treasury disbursements and reform of local allocation tax. In July 2006, in the round-table conference established by the former Minister of Internal Affairs and Communications Heizo Takenaka, a report was tabled about the specific state of the decentralization in the future. In the report, reference is made to the need to achieve the “full-freedom of local government loans” and to the need to review the “collapsed reconstruction law”. On the basis of these proposals, unified collective bargaining about conditions of the issuance of local government bonds has been abolished and a new local government finance reconstruction law is being discussed. The future progress of local financial system reform which attaches weight to the “freedom, responsibility and independence” of local governments is a critical issue for local governments. In this round-table conference report, it is proposed that the draft of a “New Omnibus Decentralization Act” should be submitted to lawmakers within three years, so as to review and reform the authority and responsibility of the central government. The six associations of local governments also request, in the “Report on the promotion of decentralization” mentioned above, the enactment of a “New Promotion of Decentralization Law”. With these background, in October, 2006, the draft of a “New Promotion of Decentralization Law” specifying the basic concept for promoting decentralization and the establishment of committees was put before lawmakers. Attention should continue to be focused on how the promotion of reform in decentralization, and the establishment of autonomy and independence of local governments is realized through the enactment of these laws.

6 Conclusion

In conclusion, a brief mention will be made of future trends in local financial system reform.

As mentioned above, the government has shifted the main emphasis from the decentralization

of authority to sound fiscal administration in the local financial system reform (trinity reform). However, they have not revised the national treasury subsidies and obligatory shares enough from the viewpoint of improving the expansion of the freedom of local governments in determining policies (measures). Under such circumstances, more attention than before needs to be devoted to the reoform of national treasury subsidies and obligatory shares and to the construction of a local financial system in which local governments can perform their duties with the autonomy and independence they require.

Some people claim that the function of the local allocation tax in guaranteeing financial resources is too strong and request a diminished role (function). However, there is a large difference in financial capability among local governments. Therefore, we should consider the necessity of “even” and “unbiased” policies for local governments and discuss the ideal situation for guaranteeing financial resources for local governments. Furthermore, there is a need to review the methods used to calculate local allocation taxes, including the introduction of new local allocation tax and simplification of local allocation tax, on the basis of justification for the existence of a local allocation tax system aimed at guaranteeing the financial resources required for local governments.

The national government and local governments are in a critical financial condition. The establishment of sound fiscal administration is a very important issue. Local governments should promote administrative and budgetary reform, and exert maximum effort to achieve effective financial and administrative operations. However, autonomy and independence are indispensable conditions in enabling local governments to execute the kinds of policies truly required for residents based on the actual condition of each region. It is important to promote the decentralization of authority on the financial front from the viewpoint of effective management of local governments. There is a greater need than ever before to establish sound local government finance and to promote the decentralization of authority on the financial front.

(Note)

- 1 Ministry of Internal Affairs and Communications (ed.). (2006). *Heisei 18 nen do ban Chihou zaisei hakusho* [White Paper on Local Public Finance, FY2006Edition], National Printing Bureau, pp.2-4.
- 2 Ministry of Finance. (2006). Highlights of the Budget for FY2007. (<http://www.mof.go.jp/english/budget/e20061224a.pdf>) p.16.
- 3 Study group on local tax allocation system: (2006). Heisei 18 nen do ban Chihou kouhu zei no aramashi [Overview of local allocation tax in 2006]. Institute of Local Finance, p.70.
- 4 Study group on local tax allocation system: *ibid.*, p.4
- 5 Kancho Sokuhou [Government Office Flash News], Jiji Press , December 16, 2005.

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1. Yano, Kohichiro. (2003). *Chihou zaisei seido (dai 7ji kaitei ban)* [Local government finance system, rev. 7], Gakuyo Shobo.
2. Okamoto, Zensho. (2006) *Susumu sanmi ittai kaikaku –sono hyouka to kadai (4)* [Evolution of trinity reform—Evaluation and Challenges (4)], *Chihou Zaimu*, vol. 625, July, 2006.
3. Komuro, Yuichi. (2006) *Sanmi ittai kaikaku no kensyo to sono sai-kouchiku ni mukete –hojyokin-tou ni yoru chiiki kakusa zesei an* [Verification and reconstruction of trinity reform—Reduction of regional differences by subsidy, etc], *Jichi kenkyu*, vol. 82, No.11, November, 2006.
4. Ikawa, Hiroshi. (2006) *Jichitai sesaku ni taisuru kuni no sekinin to zaigen hosho* [Responsibility of the central government and securement of revenues, for policies of local governments II]. *Jichi kenkyu*, vol. 82, No.11.

Table 1 Annual Revenue of Local Governments (Fiscal 2004)

Category	Revenue Settlement (Hundred million yen)	Constituent Ratio %
Local taxes	335,388	35.9
Local transfer taxes	11,641	1.2
Special local grant	11,048	1.2
Local allocation tax	170,201	18.2
Sub total (general revenue sources)	528,278	56.5
National treasury disbursements	124,598	13.3
Local government loans	123,753	13.2
Others	157,793	17.0
Total	934,422	100.0

Source: Ministry of Internal Affairs and Communications ed.: "White Paper on Local Public Finance, FY2006 Edition" National Printing Bureau, April, 2006, p.12.

Table 2 Outstanding Long-term Debt on the part of Central Government and Local Governments

	End of fiscal 1995 <Settlement>	End of fiscal 2000 <Settlement>	End of fiscal 2005 <Settlement>	End of fiscal 2006 <Revised>	End of fiscal 2007 <Budget>
Central government	297	491	590	600	607
General Bonds	225	368	527	537	547
Local governments	125	181	201	201	199
Overlap between the central and local governments	▲12	▲26	▲34	▲34	▲33
Total debt of the state and local governments	410	646	758	767	773
Share of gross domestic product	82.6%	128.1%	150.6%	150.2%	148.1%

Note:

1. Source: "Highlights of the Budget for FY2007" Ministry of Finance, December, 2006, P11.
2. GDP for FY2006 is estimated, GDP for FY2007 is forecast.

Table 3 Chronology of Local Financial Reform

- June, 1993: Resolutions about the promotion of decentralization were made (in both the House of Representatives and House of Councilors).
- July, 1995: Promotion of Decentralization Law executed and Decentralization Promotion Committee inaugurated.
- April, 2000: Omnibus Decentralization Act executed.
- June, 2001: Final report from the Decentralization Promotion Committee was published.
 "Basic policies for economic and fiscal management and structural reform (Basic policies for 2001)" was endorsed by a Cabinet decision.
- July, 2001: Council for Decentralization Reform inaugurated.
- May, 2002: "Structural reform of local public finance and transfer of tax revenue sources" (Katayama draft policy) was published.
 June "Basic policies for 2002" was endorsed by a Cabinet decision (Reform promoted by the trinity method was decided for the first time.).
 October "Opinions about the ideal state of clerical works and projects" was reported by Council for Decentralization Reform.
- June, 2003: "Basic policies for 2003 was endorsed by a Cabinet decision (4 trillion yen of subsidy and obligatory share reform was decided.).
- April, 2004: Aso, Minister of Internal Affairs and Communications (at that point in time) published the "Local financial reform for the promotion of decentralization."
 June "Basic policies for 2004" was endorsed by a Cabinet decision (Local governments were requested to prepare specific reform plans aiming to achieve a 3 trillion yen transfer of tax revenue sources.).
 August A reform plan by the six associations of local governments was proposed to the government.
- September Conference of central and local government on trinity reform inaugurated.
- November The government and ruling parties came to an agreement over "Trinity reform."
- June, 2005: "Basic policies for 2005" was endorsed by a Cabinet decision (decisions were taken on activities to ensure a steady implementation of the trinity reform by fiscal year of 2006.).
 November The government and ruling parties came to an agreement on "Trinity reform."
- June, 2006: The six associations of local governments submitted the "Report on the promotion of decentralization."
 July "Basic policies for 2006" was endorsed by a Cabinet decision.

Table 4 National Treasury Subsidy and Obligatory Share Reform and Transfer of Tax Revenue Sources

(Unit: Hundred million yen)

Category	Total amount	Breakdown of figures shown on the left			
		Fiscal 2003	Fiscal 2004	Fiscal 2005	Fiscal 2006
Amount of national treasury subsidy and obligatory share reform	52,286	5,625	10,314	36,347	
Amount related to the transfer of tax revenue sources (part of above figure)	31,176	2,344	4,749	Amount related to the agreement between the government and ruling parties in 2004.	
				17,539	
Amount related to other reform (part of above figure)	21,110	3,281	5,565	Amount related to the agreement between the government and ruling parties in 2005.	
				6,544	5,823
Streamlined amount (part of above figure)	13,167	3,281	4,235	3,011	2,640
Amount converted to grants (part of above figure)	7,943		1,330	3,430	3,183
Amount of transfer of tax revenue sources	30,094 (Fiscal 2006)				

Source: Study group on local allocation tax system, ed.: "Overview of local allocation tax in 2006", p.110, April, 2006, Institute of Local Finance.
 Study group on local allocation tax system, ed.: "Overview of local allocation tax in 2004", p.84, April, 2004, Institute of Local Finance.

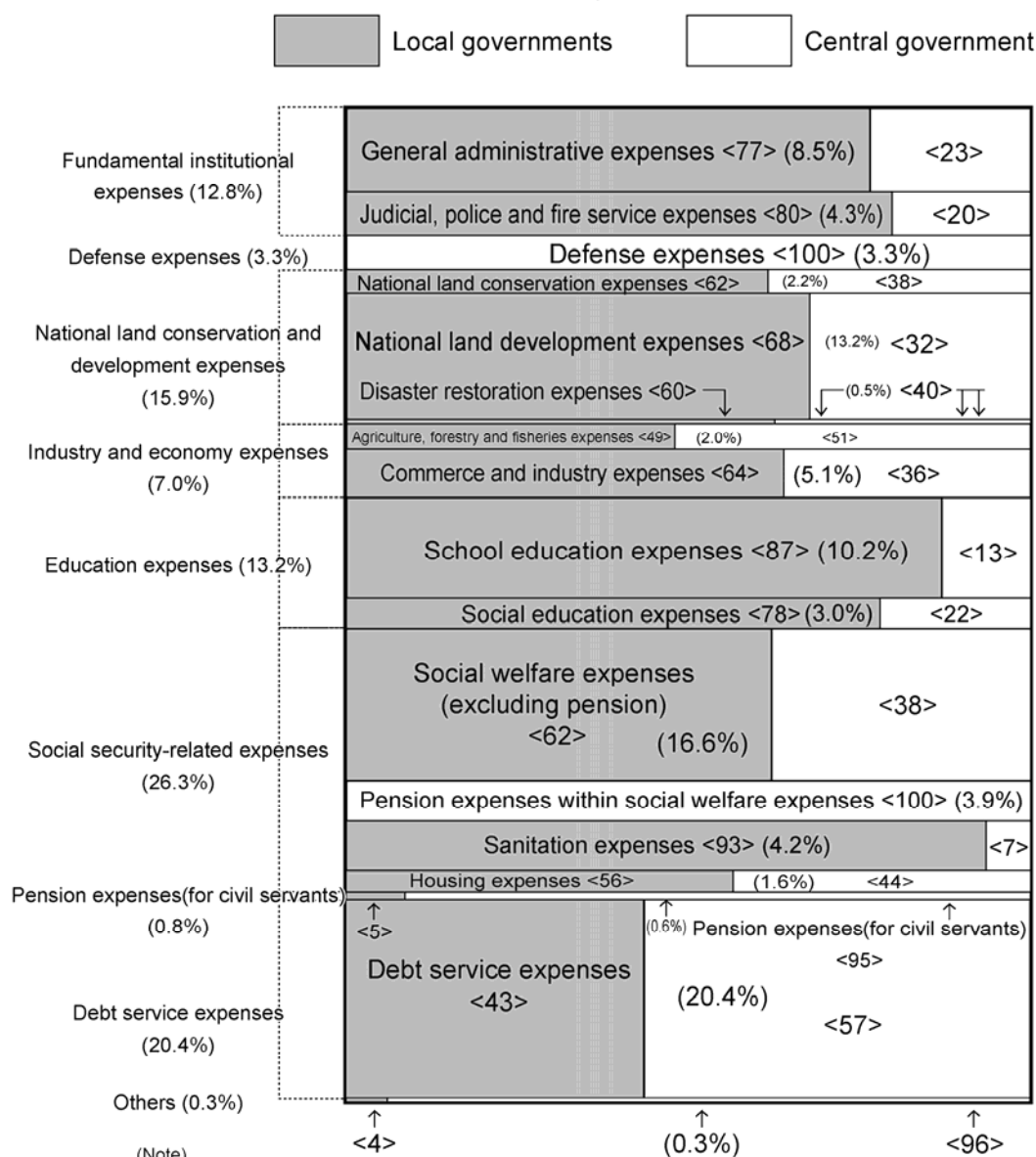
Table 5 Transition of Amount of Local Allocation Tax and Amount of Local Public Finance Program (on the basis of the original plan)
(Unit: Hundred million yen)

Category	Amount of local allocation tax		Extraordinary financial measures loan ②	Amount of substantial local allocation tax (①+②)		Amount of local public finance program		Amount of local taxes	
	①	Rates of increase(%)		Rates of increase(%)	Rates of increase(%)	Rates of increase(%)	Rates of increase(%)	Rates of increase(%)	
Fiscal 2000	214,107	2.6		214,107	2.6	889,300	0.5	350,568	▲0.7
Fiscal 2001	203,498	▲5.0	14,488	217,986	1.8	893,071	0.4	355,810	1.5
Fiscal 2002	195,449	▲4.0	32,261	227,710	4.5	875,666	▲1.9	342,563	▲3.7
Fiscal 2003	180,693	▲7.5	58,696	239,389	5.1	862,107	▲1.5	321,725	▲6.1
Fiscal 2004	168,861	▲6.5	41,905	210,766	▲12.0	846,700	▲1.8	323,231	0.5
Fiscal 2005	168,979	0.1	32,231	201,210	▲4.5	837,687	▲1.1	333,189	3.1
Fiscal 2006	159,073	▲5.9	29,072	188,145	▲9.8	831,508	▲0.7	348,983	4.7

(Note)

1. Source: Study group on local allocation tax system, ed.: "Overview of local allocation tax in 2006", p.116, April, 2006, Institute of Local Finance, etc
2. The amount of local taxes is based on the local public finance program.

Fig.1 Central and Local Government Percentage Share of Main Expenditures by Function



1. Source: Ministry of Internal Affairs and Communications ed.: "White Paper on Local Public Finance, FY2006 Edition", National Printing Bureau, April, 2006, p.3

3. Figures in () indicate the constituent percentage of expenses on a function basis.

4. Figures in < > indicate the percentage share of the central and local governments respectively in expenses on a function basis.